

# CHAPTER 1

## SCOPE AND PURPOSE OF THE INQUIRY

### Background

1.1 The *First Corporate Law Simplification Act 1995* (the Act), which amended the Corporations Law, changed the financial reporting requirements for proprietary companies. The Act replaced the previous distinction between exempt and non-exempt proprietary companies with a distinction between large and small proprietary companies based on the company's assets, revenue and employees. In February 2000, the Parliamentary Joint Statutory Committee on Corporations and Securities (PJSC) resolved to inquire into the new reporting system.

1.2 The PJSC undertook this inquiry for two reasons. When the new reporting requirements were introduced, the object of the policy was to reduce the reporting obligations of small proprietary companies. Conversely, reporting standards for large proprietary companies which have significant economic impact were strengthened. These companies would be required to prepare accounts, have them audited and lodged with the Australian Securities and Investments Commission (ASIC). The Act also established criteria for granting exemptions if the reporting requirements imposed unreasonable burdens on the companies. In two previous reports in 1995, the PJSC had noted that the large/small distinction might impose significant audit costs. This initial view was strengthened by early and significant indications of problems with the new reporting system. These emerged at the time the PJSC reviewed the Draft Second Corporate Law Simplification Bill 1996 and again, in the context of the PJSC's examination of the 1995-96 ASIC Annual Report. The PJSC decided to defer a review of the large/small test for proprietary companies until the ASIC was able to collect more reliable information on the number and size of companies affected by the change.<sup>1</sup>

1.3 The Treasurer had also foreshadowed a review of the large/small test two years after its commencement "to ensure that its practical operation does not place an undue burden on business."<sup>2</sup> The PJSC considered that the proposed review by the Treasury would be limited in scope and would not address all the problems with the new reporting system. It was important that any review should assess the effectiveness of the large/small test and consider additional measures to enhance the accountability of proprietary companies. An important development in this regard has been the extension of the duties of directors as a result of changes to the Law, such as the

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1 Parliamentary Joint Committee on Corporations and Securities, *Report on the Annual Report of the Australian Securities and Investments Commission and Other Bodies: 1995-96*, June 1997, p 7. See also *Report on the Draft Second Corporate Law Simplification Bill 1996*, November 1996, pp 38-41.

2 Hansard, *House of Representatives*, 12 December 1996, Questions on Notice, p 8648.

*Corporations Law Amendment (Employee Entitlements) Act 2000* and the *Corporate Law Economic Reform Program Act 1999*.<sup>3</sup> Common law developments have also created potential new duties of directors to shareholders, creditors and employees of the company.<sup>4</sup>

## Previous reports

### *Report on the First Corporate Law Simplification Bill 1994*

1.4 In its March 1995 report, the PJSC was unable to reach an unqualified view on the appropriateness of the large/small test and the criteria used for distinguishing between large and small proprietary companies. The test in the Bill provided that a proprietary company is small only if it satisfied at least two of the following three criteria:

- assets less than \$5 million;
- revenue less than \$10 million;
- fewer than 50 employees.

1.5 Although an estimated 98 per cent of proprietary companies would be classed as small and accordingly be exempt from the reporting requirements, the PJSC concluded that the three-part test was to a degree arbitrary. Concerns were raised that the two new categories of proprietary companies may result in incorrect classification and inadequate protection for creditors. In evidence to the PJSC, the accounting bodies proposed the reporting entity concept as an alternative to the large/small test. The benefits of the reporting entity concept were twofold: it was the more meaningful test for determining reporting obligations and it was already in use in other parts of the Corporations Law as well as the Accounting Standards.

1.6 However, the PJSC concluded, on balance, that it preferred the large/small test over the reporting entity concept as a basis for distinguishing between proprietary companies. It did so because, by comparison with the three-part test in the Bill, the reporting entity concept “does not provide a test of sufficient certainty to enable an objective assessment to be made of whether a company falls within the entity test.”<sup>5</sup> The PJSC also took into account the support for the new reporting system by the ASIC (formerly the Australian Securities Commission) and the Law Council of Australia.

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3 See Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on the Corporations Law Amendment (Employee Entitlements) Bill 2000*, April 2000, pp 7-13. The Act increased the protection for employee entitlements as well as extending the duty on directors not to engage in insolvent trading.

4 See Professor R Baxt, *Do directors owe a duty to employees? Implications of amendments to the Corporations Law and other developments*, Law Council of Australia, 22 July 2000.

5 Parliamentary Joint Committee on Corporations and Securities, *Report on the First Corporate Law Simplification Bill 1994*, 2 March 1995, p 16.

1.7 The PJSC then looked at the particular criteria in the test. It considered that of the three criteria, the threshold tests of assets and revenue were the most important and recommended that serious consideration be given to two options:

- that the employees criterion remain; or
- that the employees test be deleted from the Bill and the test for a large/small proprietary company be on the proposed assets and turnover criteria alone.

1.8 The Government did not agree to amend the Bill. It considered that the test in the Bill provided adequate flexibility. The formulation of the test was designed to achieve an approximate measure of a company's economic significance and the proposal to reduce the criteria would result in "a less appropriate test of a company's economic significance, and accordingly a less appropriate touchstone for the application of corporate financial reporting requirements."<sup>6</sup>

*Report on Items 1-4, Schedule 4 of the First Corporate Law Simplification Bill 1995*

1.9 The PJSC repeated its concerns about the potential impact of the large/small test on audit costs and the threshold criteria used in the Bill in its report tabled on 30 August 1995. Estimates of these costs ranged from \$10,000 to \$80,000 annually.

1.10 Four main approaches were suggested to overcome this problem. One option was to amend the test so that fewer companies would be classed as large proprietary companies. A second approach was to extend the ASIC's discretion to exempt companies from the requirement to have their accounts audited. A third option was to alter the requirement thereby avoiding the additional audit costs. Large proprietary companies would be able to rely on their unaudited accounts provided that an external accountant prepared the accounts. A fourth approach was to replace the large/small test with the reporting entity concept.

1.11 The PJSC noted strong concerns that in some cases the audit requirement was not justified.<sup>7</sup> It considered that the problem could be addressed by expanding and clarifying the ASIC's discretion to exempt proprietary companies from the requirement. Accordingly, the PJSC made a number of specific recommendations as to how the ASIC should exercise that discretion:

***Recommendation 1***

The Bill be amended to provide that in exercising its discretion under section 313 of the Corporations Law to exempt a large proprietary company, or class of large proprietary companies, from the audit requirement the Australian

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6 Hansard, *House of Representatives*, 9 March 1995, p 1988.

7 The Australian Chamber of Commerce and Industry and the Motor Trades Association of Australia stated that "For a number of companies with shareholding owned by family members and with borrowings mainly confined to financial institutions there appears to be a significant new compliance cost without any corresponding net public benefit".

Securities Commission should have regard to, but not be limited by, the following criteria:

- the expected cost or burden of audit;
- the expected public interest or benefit of making this information available;
- the number of creditors;
- the nature and extent of a company's liabilities;
- whether it is the first year the company is required to prepare audited accounts;
- whether the company is one which is likely to repeatedly move in and out of the large proprietary category over a period of years.

### ***Recommendation 2***

The Committee recommends that the exercise of the ASC's discretionary power in the manner described in Recommendation 1 be made subject to a process of public consultation and scrutiny. The Committee also recommends that the ASC include in its Annual Report details of how it has complied with its procedures.

### ***Recommendation 3***

The three tests contained in the proposed section 45A, the criteria for exercising the ASC's discretion, the exercise of that discretion and the effectiveness and cost of the process be reviewed by the government and this Committee after a period of two years.

### ***Recommendation 4***

In view of the delay in commencement of the legislation, the Committee recommends that the Bill be amended to defer the commencement of the audit obligation on large proprietary companies until the 1996-97 financial year.<sup>8</sup>

1.12 The Government accepted all of the above recommendations and the Bill was amended accordingly.<sup>9</sup> The Government also agreed that ASIC Class Orders should be made following a transparent consultation process and that the ASIC should include details of this in its annual reports.

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8 See Parliamentary Joint Committee on Corporations and Securities, *Report on Items 1-4, Schedule 4 of the First Corporate Law Simplification Bill 1995*, 30 August 1995, pp 13-16.

9 See First Corporate Law Simplification Bill 1995, Amendments to be Moved on Behalf of the Government.

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*‘Grandfathering’ of exempt proprietary companies*

1.13 Under the previous distinction, exempt proprietary companies were not required to lodge their accounts with the ASIC if they appointed an auditor. The new reporting system would require some of these companies to lodge audited accounts. The Bill proposed that existing companies, which have their annual accounts audited and are large and which continue to operate unchanged (‘grandfathered’ companies), would not be required to lodge accounts with the ASIC.

1.14 The PJSC at first supported the proposal in its March 1995 report. However, it reconsidered the matter in light of the evidence presented during its reference on the Bill. In its report of 30 August 1995, the PJSC referred to concerns that proposed subsection 317B(3) would allow a company already being audited, and falling within the large category, to be exempted indefinitely from lodging accounts. A secondary effect of this situation would be “the development of a trade in grandfathered companies.” The PJSC recommended that:

Whilst not within the Committee’s terms of reference, the Committee considers that the proposed section 317B(3) (the ‘grandfathering’ clause) in the Bill be amended to include a sunset period of three years from the date of commencement of the legislation.

1.15 The Government did not agree to amend the Bill to include a sunset period but recognised the need to review the grandfathering provisions as part of the same review recommended by the PJSC.

### **Conduct of the inquiry**

1.16 On 27 January 2000, the Minister for Financial Services and Regulation, the Hon Joe Hockey MP, requested the PJSC to review the test for determining whether a proprietary company is large or small and the requirements for the audit and lodgement of financial statements by proprietary companies. Subsequently the PJSC resolved to undertake a single review, which would include a review of the large/small test foreshadowed by the Treasurer.

1.17 In February 2000, the PJSC advertised for public submissions and indicated that it would review the new reporting system with particular reference to:

- the three criteria comprising the large/small test;
- the appropriateness of having requirements for audit and the lodgement of accounts for some classes of proprietary companies;
- the appropriateness of the criteria for the exercise of the ASIC’s discretion;
- the manner in which the ASIC has exercised that discretion; and
- the effectiveness and costs of the process of providing exemptions from the audit requirement.

1.18 The PJSC received 14 written submissions from individuals, proprietary companies, accounting firms and professional organisations. The PJSC held public hearings in Canberra on 28 June 2000 and Melbourne on 30 June 2000. Lists of published submissions and of witnesses who appeared at the hearings are at Appendices 1 and 2.